to focus principally on the extent to which facilities-based competitors have entered the market, as opposed to focusing on the extent to which services are being provided by resellers. Nevertheless, the existence of a single facilities-based carrier is not sufficient to conclude that the market is competitive. It may be sufficient to conclude that the process of competition evolving has begun.

Q. HAS THIS COMMISSION REACHED A SIMILAR CONCULUSION?

A. Yes. In its local competition docket, the Commission found that "Pacific and GTEC possess dominant market poewr in their local exchange market even thugh legal barriers to market entry have been lifted."[13] Moreover, the Commission found that Pacific and GTEC will maintain their "... overall market dominance ... for some time."[14]

Q. PACIFIC BELL SUGGESTS THAT THE FACT THAT IT CURRENTLY HAS ZERO MARKET SHARE DEMONSTRATES ITS INABILITY TO EXERCISE ANY MARKET POWER. DO YOU AGREE?

A. No. All that PBCom is pointing out is that it is not yet operating, not what its market share would be soon after it begins operating. As proposed by PBCom, that market share will be based, in large part, on the market power that its affiliate and venture partner, Pacific Bell, has -- the market power that it will share once operations begin.

Significantly, the position taken by PBCom on this matter in this proceeding is substantially different than that traditionally taken by Pacific Bell with regard to the impact of <u>potential entrants</u> on its marketing abilities. The RBOCs, including Pacific

[13] D.96-03-020, FOF 26.

[14] Id. at FOF 80.

Bell, regularly take the position that one must consider potential entrants into a market in determining the market power of any participant already in the market. Consider, in that regard, PBCom's view that by altering conditions of entry into the market for local services, one must conclude that market is currently competitive. Nevertheless, considering its own actions in this regard, Pacific seems to suggest that the potential market power of PBCom is irrelevant when determining its ability to affect market outcomes.

The assertion about market share is misleading in yet another regard. As I indicated, PBCom and Pacific will be the equivalent of partners in this venture. Each will exclusively market the services of the other. Hence, PBCom will necessarily inherit and share in any market power that Pacific Bell currently has. Pacific still maintains a monopoly or near monopoly position in the provision of many local telephone services, and the market power that goes with that will be shared by PBCom.

Q. ARE THERE ANY CONCERNS WITH REGARD TO THE REGULATION OF PACIFIC BELL THAT RESULT FROM THE PBCOM APPLICATION?

A. Yes. The terms and conditions under which PBCom can enter the market and function as an interLATA carrier are spelled out in Sections 251, 271 and 272 of the Act. What is of particular concern is that PBCom's ability to function and gain market share be based upon consumer preferences and PBCom's relative operating efficiencies. PBCom's market share, on the other hand, should not be linked to its ability to take advantage of market intelligence and other information uniquely available to its affiliate, Pacific Bell, as the incumbent local service provider. More specifically, customer proprietary information should be made available to all carriers, including PBCom, under equal terms and conditions, if it is to be made available at all. Similarly, Pacific Bell's customer service representatives should not be allowed to function as PBCom sales agents if PBCom is allowed to provide local service. As explained above, this is recommended because of current monopoly position of Pacific Bell as the incumbent.

Q. HOW CAN THIS "LEVEL PLAYING FIELD" COME ABOUT IF PACIFIC BELL IS ALLOWED TO JOINT MARKET PBCOM'S INTERLATA SERVICES?

A. This level playing field, or non-discrimination provision, does not impede Pacific Bell's ability to joint market any PBCom services. Nor, for that matter, does it require that Pacific Bell joint market the interLATA services of any other carrier.

The non-discrimination, or level playing field, provision, simply suggests that Pacific Bell's joint marketing activity be separated from its other regulated operations. For instance, Pacific Bell's representatives would be able to telemarket any PBCom service, even announcing that the caller is a Pacific Bell employee. On the other hand, when a subscriber contacts Pacific Bell as either the incumbent carrier in the region or as its monopoly local exchange carrier, that customer representative should not be permitted to take advantage of that unique circumstance to promote PBCom services. No other entity currently is in the same monopolistic situation with respect to the provision of local telecommunications services. The requirement is that Pacific Bell's customer service representatives must express indifference among interLATA service providers. The customer service representative can describe service options available from the various interLATA carriers, including PBCom. Further, the customer service representative can sign up any subscriber to any particular long distance carrier, just as it does today. What the customer service representative cannot do when a customer contacts Pacific Bell as the incumbent local exchange carrier is act as an agent for its affiliate, PBCom.

Q. WHAT ARE THE IMPLICATIONS OF ALLOWING THIS TYPE OF DISCRIMINATORY ACTION TO OCCUR?

A. If PBCom has the unique opportunity of taking advantage of Pacific Bell's position as monopoly or incumbent local service provider, it will necessarily have a larger market share than would otherwise be the case. Simply stated, firms that are more efficient, more innovative and produce a more desirable portfolio of products will find it more difficult to successfully enter and survive in this market. The market share of such firms will be smaller than what would otherwise be the case. The net result is higher cost, less innovation and lower consumer welfare. The benefits of competition will be diminished.

Q. WHAT IS YOUR RECOMMENDATION WITH RESPECT TO THE APPROPRIATE POLICY AND ADDITIONAL SAFEGUARDS?

A. I recommend that the Commission consider certifying PBCom to provide interLATA services only at this time, with the right to market (but not provide) Pacific's local services along with its own. This eliminates all the concerns expressed above and ensures separateness in the provision of local and long distance service.

Alternatively, I recommend that the Commission regulate PBCom as a it would the incumbent. Although PBCom may technically meet the structural separation requirement, the discrimination safeguards are not functionally met. As proposed, PBCom and Pacific have <u>no</u> intent to, and will not, act independently. Thus, PBCom becomes functionally an extension of Pacific and should, therefore, be treated as such.

Additionally, the Act requires written agreements and disclosure of the agreements between an incumbent and its affiliate. In response to data requests[15] PBCom has indicated that no such agreements exist[16] and that any such agreements would be highly confidential and proprietary. This is clearly inconsistent with the requirements of the Act.

In addition, I recommend that the Commission place certain restrictions on the proposed 'marketing' activity of Pacific. Specifically, the Commission should establish rules to enforce the provisions of the Act which prohibit Pacific Bell from providing services to PBCom on an exclusive basis; i.e., without offering equivalent services to other entities. The use of proprietary customer information exclusively for the benefit of PBCom falls into this category. This requirement, is necessary because of Pacific Bell's unique position and the possession of critical information not available from any other source.

Without these additional safeguards, Pacific and its affiliate can, in effect, bypass or circumvent the requirements of the Act.

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[15]See response to CCTA's Follow-up Questions, response 2.

[16]Response to Coalition's Third Set of Data Requests to Pacific Bell Communications, Response 4.

IV. COMMENTS ON DR. EMMERSON'S TESTIMONY

Q. AT PAGE 25 OF HIS TESTIMONY, DR. EMMERSON ARGUES THAT THE GREATEST BENEFITS OF COMPETITION OCCUR WHEN ALL PARTIES HAVE EQUAL OPPORTUNITIES TO COMPETE. DO YOU AGREE?

A. Yes. That, however, is not what PBCom is proposing. What PBCom is proposing is that it function as Pacific Bell's alter-ego.

Dr. Emmerson claims that what PBCom wants is simply an opportunity to serve customers in exactly the same manner as the large, established IXCs which have established relationships with California customers. However, as discussed previously, the "opportunity" requested by PBCom includes access to services and information from Pacific which are not available to the large IXCs. Nor is Pacific and, therefore, PBCom, without established relationships with customers in California. Pacific and PBCom recognize and are counting on the Pacific Bell name and the established relationships.

Q. DR. EMMERSON ARGUES THAT PACIFIC BELL WILL NOT BE ABLE TO USE ITS LOCAL EXCHANGE FACILITIES TO EXCLUDE PBCOM'S COMPETITORS FROM EITHER THE INTRALATA OR INTERLATA INTEREXCHANGE MARKETS.[17] HAVE YOU ANY COMMENT?

A. Yes. Dr. Emmerson's comments are misguided. The relevant question is not whether Pacific Bell will be able to use its local exchange facilities to exclude PBCom's competitors from long distance business, but whether Pacific can impart to PBCom important advantages not available to other providers of long distance services. Similarly, Dr. Emmerson's conclusions with respect to joint marketing are founded on

[17] Direct Testimony of Dr. Richard Emmerson, p. 25.

the argument that the antitrust laws prohibit tying, and Pacific cannot enforce exclusive deal arrangements with PBCom's long distance customers. However, it is not necessary for Pacific Bell to enforce exclusive tying arrangements with any entity to get the undesirable results that are of concern here. It is only necessary that Pacific Bell be able to offer services to, or information on behalf of, its affiliate that are not available to other entities on the same terms and conditions.

Q. DR. EMMERSON NOTES THAT THE ACT REDUCED BARRIERS OF ENTRY INTO THE MARKET FOR LOCAL TELECOMMUNICATIONS SERVICES. DOES THIS REDUCE THE NEED FOR DIFFERENTIAL REGULATION OF PBCOM?

A. No. There is no question that entry into the market for local exchange services is easier today than it has been in the past. However, competition is now just beginning to emerge. It must be recognized that the pace, or even the success, of competition emerging will vary across service and across geographic areas. Consequently, market power is likely to remain in many portions of the market, at least in transition. As noted, that market power will accrue to Pacific Bell and to any affiliate that partners with it in any venture.

The implication is that Pacific's monopoly power may diminish with time, not that it is diminished today. Similarly, the ability of PBCom to exert any market power may also diminish in time, but it is not diminished today. Regulating PBCom's provision of local services is appropriate and necessary if the Commission is to allow PBCom to become a reseller of local service.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

III. AFFILIATE TRANSACTION REQUIREMENTS

Q. PLEASE SUMMARIZE THE PREVIOUS COMMISSION DECISIONS WHICH HAVE ESTABLISHED THE RULES APPLICABLE TO TRANSACTIONS BETWEEN PACIFIC BELL AND ITS AFFILIATES.

A. The Commission's requirements with regard to transactions between Pacific Bell and its affiliates have been established through several Commission decisions. In Pacific Bell's first post divestiture rate case, D.86-01-026 set forth transfer pricing rules applicable to pricing services billed by Pacific Bell to affiliates and affiliate payment rules applicable to payments made by Pacific Bell to affiliates. In Pacific Bell's last traditional rate case, D.87-12-067 established a complete list of guidelines and requirements intended to govern transactions between Pacific Bell and its affiliates. That decision also enunciated the "ratepayer indifference" standard which requires that ratepayers be made indifferent to any utility-affiliate transactions by requiring compensation for any flow of benefits or resources from Pacific Bell to an affiliate. Finally, D.92-07-072 provided further amplification and clarification of the affiliate transaction rules and guidelines established in D.86-01-026 and D.87-12-067.

Q. WOULD YOU PLEASE SUMMARIZE THE COMMISSION'S AFFILIATE TRANSACTION REQUIREMENTS WHICH PERTAIN TO THE PROPOSED RELATIONSHIP BETWEEN PACIFIC BELL AND PBCOM?

A. Yes. As indicated by my description of the Commission's previous orders, a number of specific affiliate transaction rules and guidelines have been established. Among the requirements specifically applicable to the relationship between Pacific Bell and PBCom are the following:

- Affiliates such as PBCom must compensate Pacific Bell for non-tariffed services provided by Pacific Bell at a price equal to the higher of fully allocated cost plus a ten percent mark-up or market price. Fully allocated cost is as described in the Federal Communications Commission (FCC) Part 64 rules.

- Pacific Bell must formalize its transfer pricing contracts for its services prior to offering those services to an affiliate.

- An affiliate must pay Pacific Bell a transfer fee equal to 25 percent of the employee's first year salary at the new company for any employee which transfers to the affiliate from Pacific Bell.

- When goods or services are sold by an affiliate to Pacific Bell, the price paid by Pacific Bell shall be the lesser of fair market value or fully allocated cost.

- Pacific Bell may not transfer an asset to an affiliate at less than the independently appraised fair market value of that asset.

- Pacific Bell must notify the Commission at least 30 days in advance of the pending transfer to an affiliate of any asset with a fair market value of $100,000 or greater.

- Affiliates are required to pay Pacific Bell a referral fee on all successful sales referrals made by Pacific Bell. The referral fee is equal to 13 percent of the first month's revenues from the sale.

- Pacific Bell is prohibited from guaranteeing any notes, debentures, debt obligations, or other securities of Pacific Telesis or its affiliate or subsidiaries without the prior written approval of the Commission.

- Pacific Bell must meet certain compliance reporting requirements designed to facilitate further review of its affiliate transactions.

- Pacific Bell must ensure that customers will not be adversely affected as the result of the disclosure of intellectual property (e.g., patents software, copy rights, etc.)

Q. HAVE PBCOM AND PACIFIC BELL PROPOSED TO COMPLY WITH THESE REQUIREMENTS?

A. As discussed subsequently, Pacific Bell has not yet entered into a transfer pricing contract for the marketing services it intends to provide for PBCom. Other than that, Pacific Bell and PBCom have proposed to comply with the Commission's affiliate transaction rules.

Q. WILL THESE RULES ENSURE THAT THE RELATIONSHIP BETWEEN PACIFIC BELL AND PBCOM IS REASONABLE AND PROPER AND IN THE BEST INTERESTS OF CALIFORNIA TELECOMMUNICATIONS CUSTOMERS?

A. No, they will not. The rules and requirements which the Commission has established to govern the relationships between Pacific Bell and its affiliates were developed primarily to protect Pacific Bell's regulated ratepayers in a traditional rate of return/rate base regulatory environment. As noted by the Commission in D.87-12-067, the fundamental objective in establishing the affiliate transaction guidelines applicable to Pacific Bell was to ensure that ratepayers were financially indifferent to the operations of affiliates or subsidiaries by compensating ratepayers for any resources or benefits which flow from Pacific Bell to its affiliates. While the affiliate transaction rules and requirements serve a valuable purpose in protecting ratepayers in a traditional rate base/rate or return environment, they are far less meaningful in today's changing regulatory environment.

Q. PLEASE EXPLAIN.

A. The existing affiliate transaction rules were designed to require an affiliate to compensate Pacific Bell for the use of information or resources so that Pacific Bell's ratepayers are not unfairly burdened or overcharged. Under traditional regulation, the payments which Pacific Bell receives from PBCom for asset transfers, employee transfers, sales referrals and the provision of services would reduce Pacific Bell's revenue requirements. All else being equal, this would result in reduced rates to Pacific Bell's customers and reduced income to Pacific Telesis as a whole.

Under the New Regulatory Framework (NRF) in which Pacific Bell operates today, the compensation that Pacific Bell will receive from PBCom for assets, employee transfers, sales referrals, and the mark-up on non-tariffed services is not likely to be so significant that it will cause Pacific Bell to exceed the earnings cap.[1] And, unless the dollars become so significant that Pacific Bell does overearn and the sharing provisions of the NRF become effective, the fact that PBCom pays the various fees and charges to Pacific will result in no benefit to ratepayers and will have no effect on Pacific Telesis Corporation's bottom line. That is, Pacific Bell's rates would remain invariant regardless of what payments PBCom makes to Pacific Bell. Instead, the payment of employee transfer fees,

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[1]This is particularly the case in light of the revenue losses which Pacific Bell is likely to incur as the result of the entry of PBCom into Pacific Bell's markets, as discussed subsequently.

sales referral fees and a mark-up on non-tariffed services will simply result in dollars being moved from one Pacific Telesis subsidiary to another with no change in the overall profits of the consolidated corporation.

In short, the affiliate transaction rules imposed by the Commission are intended to impact cost allocation and cost recovery, not to affect behavior in today's changing regulatory environment. The Commission's rules cannot prevent the sharing of information between Pacific Bell and PBCom, control the manner in which Pacific Bell performs marketing for PBCom or ensure that Pacific Bell and PBCom operate independently because those rules do not alter the inherent economic incentives which will affect behavior. Hence, the Commission's affiliate transaction rules cannot be relied upon to ensure that the relationship between Pacific Bell and PBCom is proper and in the best interests of California telecommunications customers.

IV. TELECOMMUNICATIONS ACT OF 1996

Q. PLEASE EXPLAIN THE PROVISIONS OF THE TELECOMMUNICATIONS ACT OF 1996 WHICH ADDRESS THE RELATIONSHIP BETWEEN PACIFIC BELL AND PBCOM.

A. The provisions which address the relationship between Pacific Bell and PBCom are addressed in Section 272 of the Telecommunications Act of 1996 (TA 96 or the Act). Section 272(a) of the Act provides that a Bell operating company (BOC) such as Pacific Bell may only offer interLATA services in its own region through a separate affiliate. Section 272(b) sets forth the structural and transactional requirements applicable to the BOC and its affiliate. Specifically, Section 272(b) states that "The separate affiliate required by this section --